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The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity

An Economic Analysis of the Implications of A La Carte Pricing on Cable Customers

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Booz | Allen | Hamilton

Booz Allen's report addressed the following questions

- Key questions addressed by the study:
  - What would be the likely impact on consumer pricing?
  - What would be the likely impact on programming diversity?
- To determine this, we examined how mandatory a la carte access to program networks would impact the economic models of program networks and cable operators
  - Incremental costs to establish an a la carte option
  - Impact on revenues and costs
  - Viability of different players and ability to invest in the business

We evaluated three scenarios

1. Pure A La Carte	2. Combined Tier/ A La Carte	3. Themed Tiers
• All networks offered on current tiers (analog and digital) available on a la carte basis • Operators no longer permitted to offer any tiers beyond broadcast basic (i.e., local stations) • Operators upgrade all households to digital service	• Operators continue to offer tiers, but must provide option to receive any of the networks in these tiers on a la carte basis • A la carte only available to digital subscribers (households receiving a la carte service require digital set-top boxes for all TVs)	• Operators provide themed tiers in addition to current tier offerings (e.g., sports, family entertainment) • Operators set network line-up (likely 10 to 20 networks per themed tier) • Available on digital only, requiring digital set-top boxes for all TVs

For each scenario, we modeled two extreme cases — the outcome would likely be between the two

<table>
<tr><th></th><th>Response A:
Networks Increase
Total Affiliate Fees</th><th>Response B:
Networks Reduce
Programming Expense</th></tr>
<tr><td>Cable Networks</td><td>• Advertising drops in proportion to lost viewing and due to decrease in ad dollars/rating point
• Marketing costs increase
• Affiliate revenue increases to counterbalance lost advertising and increased marketing costs
• Programming costs remain constant</td><td>• Advertising drops in proportion to lost viewing and due to decrease in ad dollars/rating point
• Marketing costs increase
• Affiliate revenues stay constant
• Programming cuts offset impact on cash flow to the extent feasible</td></tr>
<tr><td rowspan="2">Cable Operators</td><td colspan="2">• Operators price new offerings to maintain current cash flow
• Additional set-top boxes priced at breakeven
• Additional costs of customer care and duplicated spectrum are borne by all consumers</td></tr>
<tr><td>• Programming costs increase</td><td>• Programming costs remain constant</td></tr>
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Our primary conclusions

- Consumers would be worse off under each of the scenarios evaluated
  - Would pay higher prices for cable even if keeping current tiers
  - Would need to receive fewer channels than they regularly watch in order to reduce their monthly bill below current levels
  - Would enjoy less programming diversity
- Emerging program networks would fail or would be sold to larger groups
  - Emerging program networks would likely not be able to raise license fees enough to offset lost advertising and higher marketing expenses
  - 50-75% of emerging networks would fail or be sold, and new network launches would become extremely rare
- Established networks would need to substantially reduce investments in original programming to remain viable

Consumers would face higher prices even if most kept current tiers

Costs of Establishing A La Carte or Themed Tier Options

- *Higher marketing costs for networks given risk of lost subscribers*
- *Opportunity cost of duplicated spectrum*
- *Higher call center costs to explain new options*
- *More complex billing*

Higher Consumer Rates

- 7% to 15% higher monthly cable bills for those keeping current tiers
- Lower end of this range reflects "floor" even if very few took a la carte
- Upper end of this range reflects 50% of consumers taking a la carte

If 50% of consumers migrated to a la carte, then those taking a la carte would face a substantial price increase to receive only 10 to 15 cable networks

Response A:
Networks Increase Total Affiliate Fees

	A La Carte		
	Scenario 1	Scenario 2	Scenario 3
Program-ming Cost	16.6%	2.4%	3.0%
Set-Top Boxes	15.7%	15.7%	15.7%
Customer Care	4.0%	3.2%	3.2%
Total	36.3%	21.3%	21.9%
Opportunity Cost of Spectrum	-5.9%	1.9%	1.4%
Total	30.3%	23.2%	23.3%

Response B:
Networks Reduce Programming Expense

	A La Carte		
	Scenario 1	Scenario 2	Scenario 3
Program-ming Cost	0%	0%	0%
Set-Top Boxes	15.7%	15.7%	15.7%
Customer Care	4.0%	3.2%	3.2%
Total	19.7%	18.9%	18.9%
Opportunity Cost of spectrum	-5.9%	1.9%	1.4%
Total	13.8%	20.8%	20.3%

Consumers would have to take fewer channels than they regularly watch today to reduce their monthly bill

Factors Limiting Ability to Lower the Monthly Bill

- Programming less than half of current operator expenses
- Operators will price to cover incremental costs
- Consumers will need to pay for additional digital set-top boxes

Likely Pricing by Cable Operators

- Average of $4 to $5 per channel taken a la carte, higher for some networks and lower for others
- Minimum of $15 for broadcast basic and $4 per digital set top box before pick and choose channels or themed tiers

Channels Before Consumer Faces Higher Monthly Bill

- Six cable networks for current analog customers (that currently lack digital set-top boxes)
- Nine cable networks for current digital customers (that already have set-top boxes)

Programming diversity would suffer

Impact on Program Networks	Implications for Consumers
• 20% to 60% of advertising revenues would be lost for most networks • Need to spend an additional 20% of revenues on marketing (based on premium network and consumer goods benchmarks) • Need to raise license fees to operators and cut programming expenses to maintain viability	• Half to three-quarters of emerging program networks would likely fail, reducing program diversity • Remaining networks would significantly reduce investment in original programming • New network launches would be extremely rare • Consumers would lose opportunity to sample networks (about 25% of viewing today)

A la carte would reverse recent consumer benefits

- More than half the growth in cable viewing is for newer networks that consumers can sample due to stable distribution of fixed tiers

- Consumers have enjoyed falling real costs per viewing hour — under a la carte or themed tiers, consumers would pay more to watch less

- The trend towards significant investments in original programming on cable would likely be reversed under a la carte

In summary

- The cost of establishing a la carte or themed tier options would drive up the cost of providing cable service to everyone, even if few consumers took advantage of such options

- Consumers would have to take far fewer channels than they regularly watch today in order to pay less per month

- Programming diversity would suffer, as many networks went off the air, as networks cut back programming expenditures to remain viable, and as new network launches became much less likely

- Further consolidation among program networks would be likely